

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: McClintock Analyst: Gloria McConnell Bill Number: AB 1061

Related Bills: _____ Telephone: 845-4336 Amended Date: 04-05-99

Attorney: Janet Ballou Sponsor: _____

SUBJECT: Low-income Medical Cost Refundable Credit

SUMMARY

Under this bill, a qualified taxpayer whose family income is between 100% and 200% of the federal poverty level (FPL) would be allowed a refundable credit for certain medical costs. A "qualified taxpayer" would be any individual:

- not otherwise eligible for Medicare; or
- 65 years of age or older, but only with respect to medical costs that are not covered by Medicare.

The credit amount would be equal to all medical costs above 2% of the family income for families between 100% and 150% of the FPL. For families with income above 150% of the FPL, the percentage of family income above which the credit is allowed would incrementally increase and would range from 2.5% to 5%, depending upon the income amount.

The bill would repeal various health programs now available to low-income people and appropriates to the Franchise Tax Board (FTB) savings from the repeal of those programs to make the refundable credits under this bill.

SUMMARY OF AMENDMENTS

This amendment provides that for those individuals 65 years of age and older, the credit would apply for those medical costs not covered by Medicare. (FTB had not completed an analysis of the bill as introduced.)

EFFECTIVE DATE

The bill would be effective January 1, 2000, but the credit would be operative for taxable years beginning on or after January 1, 1999.

PROGRAM HISTORY/BACKGROUND

The federal Census Bureau issues the statistical version of the poverty measure (poverty thresholds). Poverty guidelines are issued by the federal Department of Health and Human Services (DHHS) and are used in determining financial eligibility for certain federal programs. Both the thresholds and guidelines are updated annually for changes in the Consumer Price Index (CPI). However, the poverty guidelines are designated by the year in which they are issued. For instance, the guidelines issued in February 1998 are designated the 1998 poverty guidelines, but reflect only the CPI through calendar year 1997. So they are approximately equal to the calendar year 1997 poverty thresholds.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	<u>X</u> PENDING

Department Director

Date

Gerald Goldberg

4/27/1999

The 1999 poverty guidelines scheduled to be published in the Federal Register on March 18, 1999, generally will reflect calendar year 1998 poverty thresholds. Under the 1998 guidelines, the poverty level for one person is \$8,050, with generally \$2,800 added for each additional person for family units of less than eight persons. For a four-person family the poverty level is \$16,450.

According to the DHHS, no universal administrative definition of "income," "family," "family unit," or "household" is valid for all programs using the poverty guidelines. Programs that use poverty guidelines in determining eligibility may use administrative definitions of "income" that may differ from the following statistical definition. For statistical purposes, "income" generally includes, but is not limited to, total annual cash receipts, net receipts from a self-employed farmer, social security payments, railroad retirement, unemployment compensation, strike benefits, workers' compensation, public assistance, and child support. For statistical purposes, income generally does not include, among other things, capital gains, amounts from the sale of a house, tax refunds, or employer-paid benefits. For statistical purposes only, a "family" is a group of two or more persons related by birth, marriage, or adoption who live together. All related persons are considered members of one family. For example, an older couple, their daughter and her husband and two children and the older couple's nephew all living in the same housing unit would be considered members of a single family. A household consists of all persons who occupy a housing unit whether they are related.

Franchise Tax Board (FTB) primarily administers the Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (BCTL). The FTB, however, also administers several non-tax programs, such as Homeowners and Renters Assistance (HRA), audits under the Political Reform Act (PRA), and several delinquent debt collection functions. The Homeowners and Renters Assistance (HRA) program generally provides property tax relief to senior citizens and disabled individuals based on a certain percentage of the property tax or the tax equivalent for renters. This percentage varies inversely to the claimants' income levels and ranges from 4% to 96%. To be eligible for assistance, the claimant's total household income for the prior calendar year cannot exceed \$33,132. Total household income consists of adjusted gross income (as computed for tax purposes) increased by nontaxable income including social security, cash public assistance, pensions and annuities (not otherwise taxable), unemployment insurance, tax-exempt interest, life insurance proceeds, gifts in excess of \$300, and worker's compensation payments. Also, the gross household income cannot exceed \$60,240. Gross household income is total household income plus all non-cash business expenses such as depreciation, amortization, and depletion. This program is administered separate and apart from the Personal Income Tax (PIT) program. The HRA amount represents a partial reimbursement of the previous fiscal year's property taxes on personal residences paid directly by homeowners and indirectly by renters. Relief for homeowners is based on a percentage of the property tax and for renters it is a fixed assumed amount. Claimants generally file for assistance from May 15 through August 31, inclusive. It takes up to 15 weeks to process a claim. This historically has been a relatively small program. During 1998, FTB processed approximately HRA 158,000 claims averaging less than \$100 per claim. For 1999, the workload is expected to more than triple because of legislation last year (AB 2797) that increased eligibility due to inflation adjustments to the income levels.

SPECIFIC FINDINGS

Under current state and federal law, individuals who itemize can deduct the amount of certain unreimbursed medical care expenses, as defined in Internal Revenue Code (IRC) Section 213(d), paid during the year for themselves, spouses and dependents, that exceed 7.5% of adjusted gross income.

Certain small employers (as defined), their employees and self-employed individuals can deduct limited contributions to a medical savings account (MSA), if the small employer provides high deductible health coverage (which is generally considered to cover catastrophic costs) for that taxpayer and/or family. The contribution is limited based on the amount of the annual deductible under such coverage.

The PITL provides six personal income tax rate brackets ranging from 1% to 9.3%. For 1998, individuals (couples) are required to file a tax return if, excluding, among other items, social security, unemployment compensation, their California adjusted gross income (AGI) exceeds \$8,498 (\$16,996 married) or if their gross income from all sources exceeds \$10,623 (\$21,246 married).

Under this bill, any individual, whose family income is between 100% and 150% of the FPL and is not eligible for Medicare, would be allowed a credit equal to all medical costs above 2% of that family income. In the case of an individual 65 or older a "qualified taxpayer" would be any individual, but only with respect to medical costs that are not covered by Medicare. For families with income above 150% of the FPL, the credit would be the amount of medical costs in excess of the following amounts:

For families with incomes between:	Covers medical costs above:
150 and 158% of FPL	2.5% of family income
158 and 167% of FPL	3% of family income
167 and 175% of FPL	3.5% of family income
175 and 183% of FPL	4% of family income
183 and 192% of FPL	4.5% of family income
192 and 200% of FPL	5% of family income

Generally, the 1998 federal poverty level guidelines, which reflect 1997 CPI changes, are as follows:

Size of Family Unit	48 Contiguous States and D.C.	Alaska	Hawaii
1	\$ 8,050	\$10,070	\$ 9,260
2	10,850	13,570	12,480
3	13,650	17,070	15,700
4	16,450	20,570	18,920
5	19,250	24,070	22,140
6	22,050	27,570	25,360
7	24,850	31,070	28,580
8	27,650	34,570	31,800
For each additional person, add	2,800	3,500	3,220

In order to claim the credit, the "filer's" children must be enrolled in at least a minimum health care plan to cover catastrophic costs.

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business, i.e., amounts paid for their employee's insurance benefits. Employer-provided coverage under an accident or health plan or an MSA is not includible as gross income of the employee.

Under this bill, employers who provide health insurance for employees could make direct payment to the health plan of the employee's choice.

Currently, many tax returns are filed by professional tax preparers. Additionally, FTB works with volunteers who prepare tax returns. FTB provides information to taxpayers and tax preparers through seminars, forms/instructions, tax news publications and media events.

Under this bill, FTB, in cooperation with the Department of Health Services (DHS), would be required to make direct contact with all qualifying families.

The PITL allows numerous credits to encourage certain activities, but no credit is refundable. Estimated taxes, which are paid by the taxpayer, and amounts withheld by the taxpayer's employer are remitted during the taxable year. When these payments exceed the tax shown on the tax return, a refund cannot be made until after the close of the taxable year and the tax return for the year is filed.

Under this bill, "filers" qualifying for the credit may file a preliminary tax return estimating the family's anticipated tax liability for the year, qualified medical costs incurred, and estimated refund due, "to be applied against their actual tax return."

Under PITL, PIT moneys received are credited to the PIT Fund. After making PIT refunds, under current practice, the balance in the PIT Fund is transferred daily to the General Fund. Under PITL there is a disbursement fund, the Tax Relief and Refund Account, for which all moneys are continuously appropriated for issuing all refunds. To fund this account for the previously refundable renters' credit, funds were appropriated through a line item in the annual Budget Act to this fund in an amount equivalent to the renters' credit, as determined by FTB. Similarly, moneys are transferred from the Disability Fund to the Tax Relief and Refund Account for making refunds or credits of excess SDI.

According to Department of Finance, approximately \$22 billion currently is budgeted for costs associated with programs that would be repealed by this bill, of which \$20 billion is for Medi-Cal. Approximately one-half of the \$22 billion is paid from the General Fund.

For purposes of the refunds that would be claimed **under this bill**, the bill makes a first-year appropriation from the General Fund to the FTB in an amount equal to the amount of revenues saved by the programs, including Medi-Cal, eliminated by this bill.

Policy Considerations

- The bill would allow taxpayers to file a preliminary return estimating the tax, medical costs and refund. It is implied that from this preliminary return FTB would refund an amount to the claimant before the due date of the tax return. This should be clarified.
- Historically, refundable credits (such as the state renter's credit and the federal Earned Income Tax Credit) have had significant problems with fraud. The amount subject to refund under this bill would be virtually unverifiable, providing a significant incentive for fraud.
- This bill would repeal Medi-Cal programs; however, most Medi-Cal programs help persons below the poverty level, who would not benefit from this bill.
- FTB's expertise is tax administration. This bill could place FTB in the position of potentially processing more claims for medical costs assistance than tax returns. Moreover, since the bill implies that the intent is to allow refunds during the tax year with the filing of a preliminary return, the potential for fraud may be enhanced. To the extent that preliminary returns and related refunds are intended, the processing system would be significantly different from FTB's current PIT processing system. The lack of a requirement for automated verification from a reliable third party of the eligibility of the individual and the medical cost information is a significant difference from FTB's current PIT processing and system design. The magnitude and sheer size of this program could interfere with or disrupt the existing tax processes and system.
- Many individuals affected by this bill would not otherwise have a filing requirement. To require these individuals to become part of the tax system in order to receive assistance for their medical costs would add confusion to the tax system and this group of individuals.
- For taxpayers with children to claim the credit the taxpayer's child must be enrolled in at least a minimum health care plan to cover catastrophic costs. It is unclear why only children are required to have a health care plan and not the taxpayer and/or spouse, or other lineal descendants who are members of the household.
- Current law allows MSA contributions to be deducted in arriving at AGI. This bill would allow the taxpayer to use the same contribution to determine the tax credit under this bill.
- This bill does not specify a repeal date. Credits are typically enacted with a repeal date to ensure that the Legislature reviews the credit's effectiveness.
- Many terms used in this bill for the tax credit appear to be those used to administer social or health service programs. Unintended results may occur when using these definitions in conjunction with the tax system.

For example, the term "income" for purposes of establishing poverty levels generally includes income not subject to tax (social security, general assistance, child support, unemployment compensation, disability). The members of a person's household taken into consideration for establishing poverty thresholds may include persons who would have to file their own tax return. It is also unclear as to the treatment of married taxpayers who file separate tax returns under PITL.

- For the taxable year that the individual would file a preliminary return (claim) to receive assistance, the federal poverty guidelines reflecting the CPI changes for that year would not be available. Not until after the close of the taxable year when the taxes for that year are due and payable would the poverty level guidelines relating to that tax year be available. For example, if individuals were filing preliminary returns during taxable year 1998, the 1998 published poverty level guidelines will reflect only the CPI through calendar year 1997. The 1999 poverty level guidelines reflecting the 1998 CPI changes was scheduled to be available on March 18, 1999.
- The federal Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (the Act) requires states to eliminate a broad array of state and local benefits, including health benefits, to certain illegal aliens within the U.S. Under the Act, these aliens are ineligible to receive publicly funded health care services. The refundable credit authorized by this bill is likely a benefit covered by the provisions of the Act. If the author intends otherwise, the issue needs to be directly addressed in the bill.

Implementation Considerations

This bill could not be implemented without amendments to resolve the following considerations. In any event, implementing and administering this bill in conjunction with the department's existing PIT return process and computer system would be extremely difficult and costly. Additional implementation considerations may be identified as the bill is further developed.

- The department has not administered a refundable tax credit since the renter's credit was suspended in 1993. Establishing a refundable tax credit program would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.
- Because this bill is operative for years beginning on or after January 1, 1999, and assuming it is effective on January 1, 2000, taxpayers could file for monetary assistance as early as January 1, 2000, for tax year 1999.
- Unless this bill is enacted early this year, given the major impact this bill would have on FTB's processing and systems and the need for FTB staff to continue to focus on Y2K implementation, it would be extremely difficult, if not impossible, for staff to ready systems and processes to accommodate these 1999 assistance claims on or immediately following January 1, 2000.

- Without additional or clarifying definitions or statutory clarity, confusion between FTB staff and the taxpayer could exist in the following areas:
 1. It is unclear from what source FTB or taxpayers would determine "federal poverty levels" and from what year. If there is a delay in the establishment and/or publication of the federal poverty level threshold or guideline for a given year, it is unclear as to how this credit would be administered for that year.
 2. It is unclear as to how FTB would determine "medical costs that are not covered by Medicare." These credit provisions should set forth the eligibility requirements or at a minimum reference the official source that clearly indicates who is eligible for Medicare.
 3. It is unclear what "medical care" costs would be includible in determining the credit amount. "Medical care" for tax purposes may not be what the author intends for purposes of health services and this bill.
 4. It is unclear as to the definition of "well-baby" and "well-child care."
 5. It is unclear whether the requirement that the "filer's" children have at least minimum health care to cover catastrophic costs applies only to children who are members of the taxpayer's household. Additionally, it is unclear whether the costs must be merely incurred, without regard to payment.
 6. It is unclear how FTB, or DHS, would identify all qualifying families and what is meant by "direct contact." It is unclear whether all qualifying families would want "direct contact" by a taxing agency and whether for these individuals this is a disclosure or confidentiality issue.
 7. The bill implies that the taxpayer could file for monetary assistance based on medical costs incurred during the taxable year, before the tax return is filed. In filing the preliminary tax return to receive the assistance, it is unclear under what rules the taxpayer would estimate the family's anticipated tax liability (i.e. based on prior year's tax return, annualizing current year income using the prior year's tax rate since the current rate would be unknown). It is also unclear if the return could be filed at anytime during the year and whether it would be considered a tax return or claim.

Furthermore, it is unclear if an individual who files a claim would be required to file a tax return. Additionally, it is unclear as to the due date of the preliminary return and whether the return would be subject to audit and the usual statute of limitations for making a deficiency assessments, in the event the taxpayer made an error in filing the preliminary return.

- The appropriation provided in the bill would generally apply to costs associated with payments issued for the fiscal year during which the bill is enacted, 1999/2000. To allow for the assistance payments to be

continually issued by the Controller without regard to fiscal year, the bill should allow for a continuous appropriation. Additionally, the bill should authorize the Controller, through the annual budget process, to transfer from the funding source, as needed, to the Tax Relief and Refund Account sufficient funds to pay for the assistance and an alternative funding source for any period during which California may be without a budget.

Technical Considerations

- Under the PITL, the amount returned to the individual is referred to as a "refund." Under HRA, a claimant receives monetary assistance. Under this bill, it appears that monetary assistance would be given the individual rather than a "refund" of taxes.
- It is unclear why DHS would be required to maintain a list of insurance plans meeting federal standards as a component of this credit, when only children must be enrolled in a health care plan and the plan does not expressly have to meet federal standards.

FISCAL IMPACT

Departmental Costs

Impact to the department's costs cannot be determined until the implementation considerations are resolved, but it is anticipated that given the nature of the program and the volume of claims that would be filed under this bill, the department's costs would be significant.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following order of magnitude revenue losses.

Estimated Revenue Impact of AB 1061 As Introduced 2/25/99 [\$ In Millions]		
1999-00	2000-01	2001-02
(\$500)	(\$800)	(\$1,200)

The bill would be effective with income years beginning on or after January 1, 1999, with enactment assumed after June 30.

Estimates assume qualified taxpayers would continue to incur medical costs in a manner consistent with recent history for these consumers.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The number of qualified taxpayers and the amount of medical costs that exceed specified percentages of family income would determine the revenue impact of this bill. The estimate was developed by projecting the number of qualified taxpayers, projecting medical costs in excess of specified percentages of family income, calculating an average credit, and applying a series of assumptions to reflect the rate of participation of qualified taxpayers.

From state and federal data, California's population with family income between 100% and 200% of poverty is estimated to be about 17.5% of total population (roughly 6 million persons). Persons per family unit (estimated at 2.2 persons) reduce the estimate of qualifying households. The estimate is further reduced for an assumption for filers whose children are not enrolled in at least a catastrophic health care plan.

Qualified medical costs were estimated from data describing national household spending on health care. Health care spending was identified as a percent of family income for income classes between 100% and 200% of poverty thresholds based on size of family unit. (For the estimate, it is assumed that FPLs are determined using the money definition of income and does not reflect non-cash benefits.) Family income and medical costs were grown to out years. For each family income class, the calculated percentage (health care spending to family income) was multiplied by family income to derive total medical costs for each income class. For qualified taxpayers, annual medical costs ranged from a low of \$1,790 to a high of \$2,425 at 1999 levels. Medical costs in excess of specified percentages were calculated to derive an average credit for all classes of family income between 100% and 200% of FPLs. For the 1999 taxable year, the average credit is approximately \$1,250.

The average credit is multiplied times the number of qualified taxpayers to derive a potential aggregate credit amount. This amount is reduced for assumptions about the rate of participation by qualified taxpayers in the initial and subsequent years of the proposed credit. Assuming a maximum participation rate of two-thirds is reached by the fifth taxable year, deductible/refundable credits are projected to be on the order of \$2 billion annually.

BOARD POSITION

Pending.